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Volume 49 | Issue 4

Article 3

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2004

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### Recommended Citation

Michael A. Perino, *SEC Enforcement of Attorney up-the-Ladder Reporting Rules: An Analysis of Institutional Constraints, Norms and Biases*, 49 Vill. L. Rev. 851 (2004).

Available at: <https://digitalcommons.law.villanova.edu/vlr/vol49/iss4/3>

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# SEC ENFORCEMENT OF ATTORNEY UP-THE-LADDER REPORTING RULES: AN ANALYSIS OF INSTITUTIONAL CONSTRAINTS, NORMS AND BIASES

MICHAEL A. PERINO\*

## I. INTRODUCTION

IN their paper<sup>1</sup> and in their earlier comments to the SEC on the proposed attorney reporting rules,<sup>2</sup> Professors Cramton, Cohen and Koniak do an excellent job recounting the genesis of the attorney reporting requirements in the Sarbanes-Oxley Act, describing the SEC's proposed and final rules and critiquing the rule's triggering mechanism and now apparently shelved noisy withdrawal requirement. Their case study of the recent Spiegel, Inc. independent examiner's report<sup>3</sup> is a particularly useful vehicle for examining the practical implications of the SEC's policy and drafting choices. Although I was a member of a committee that submitted comments opposed to noisy withdrawal,<sup>4</sup> there is much in their paper with which I agree. Specifically, given that the corporation is the client, it is hard to argue against up-the-ladder reporting. I would also agree that the triggering mechanism as adopted is difficult to apply; although, as I explain later, I think there may be a rational explanation for why the SEC chose that particular articulation.<sup>5</sup> While I disagree with Professors Cramton, Cohen and Koniak on the wisdom of mandating

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\* Professor of Law, St. John's University School of Law. The author would like to thank John Barrett, Rob Vischer and Cheryl Wade for helpful comments and suggestions. Jordan Costa provided excellent research assistance. All remaining errors are my own.

1. See generally Roger C. Cramton, George M. Cohen & Susan P. Koniak, *Legal and Ethical Duties of Lawyers After Sarbanes-Oxley*, 49 VILL. L. REV. 725 (2004).

2. See Letter from Professors Susan P. Koniak, Roger C. Cramton & George M. Cohen, to Securities and Exchange Commission (Apr. 7, 2003), available at <http://www.sec.gov/rules/proposed/s74502/lawprofs040703.htm> (commenting on implementation of SEC standards of professional conduct for attorneys); Letter from Professors Susan P. Koniak, Roger C. Cramton & George M. Cohen, to Securities and Exchange Commission (Dec. 17, 2002), available at <http://www.sec.gov/rules/proposed/s74502/skoniak1.htm> (same).

3. See generally Indep. Exam'r Report, SEC v. Spiegel, Inc., No. 03C-1685, 2003 U.S. Dist. LEXIS 17933 (N.D. Ill. Sept. 5, 2003), at <http://www.sec.gov/Archives/edgar/data/276641/000094787103002136/0000947871-03-002136.txt>.

4. See generally Letter from Edwin David Robertson, Chair, Task Force on Corporate Responsibility, New York County Lawyer's Association, to Securities and Exchange Commission (Apr. 1, 2003), available at <http://www.sec.gov/rules/proposed/s74502/edrobertson1.htm>.

5. See *infra* Part II.

noisy withdrawal, there is little to be gained from rehashing the already copious arguments against that provision.<sup>6</sup>

Instead, I want to follow in the tradition of many symposium comments, which effectively say, “the principal paper was interesting, but this is what I really want to talk about.” What I really want to talk about is the SEC as an institution. What institutional features may impact the SEC’s willingness or ability to enforce these lawyer conduct rules vigorously in the future? This kind of institutional analysis is important because one of the primary justifications for requiring the SEC to promulgate and enforce these reporting rules is the perceived failure of state bar authorities to discipline transactional lawyers.<sup>7</sup> This Comment suggests, however, that with respect to enforcing professional responsibility rules the SEC shares many characteristics with state bar authorities and that it is therefore reasonable to expect a very similar pattern of enforcement.

This prediction is not meant to suggest that Section 307 is unlikely to yield any benefits. Indeed, the SEC’s new reporting rules seem to have had a salutary effect already because they appear to have substantially influenced the ABA’s amendments to Model Rules 1.6 and 1.13.<sup>8</sup> The mere presence of these lawyer reporting rules—especially in a post-Enron environment where courts and regulators may be less willing to believe that lawyers were simply innocent bystanders—will likely cause more lawyers to report illegal acts up the ladder, even if the prospect for a disciplinary proceeding is remote. If such an increase in up-the-ladder reporting occurs, it may lessen the impact of financial wrongdoing at publicly traded companies. Thus, Section 307 may have important benefits even in a low-enforcement environment.

This Comment proceeds as follows. Part I takes an agency-wide perspective and focuses on the SEC’s budget and personnel constraints and the already enormous demands on the SEC’s scarce resources. Part II sketches the potential influence of cultural norms, constraints and staff

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6. See, e.g., Evan A. Davis, *Past Efforts and Future Possibilities: The Meaning of Professional Independence*, 103 COLUM. L. REV. 1281, 1283 (2003) (criticizing noisy withdrawal as moving “in a very wrong direction”); Jill E. Fisch & Kenneth M. Rosen, *Is There a Role for Lawyers in Preventing Future Enrons?*, 48 VILL. L. REV. 1097, 1138 (2003) (asserting doubts about ability of “mandatory reporting up” to prevent future corporate governance scandals and arguing that new requirement is “unlikely to change lawyer behavior substantially”).

7. Congress was quite explicit about this connection. In debating Section 307, Senator Michael Enzi stated:

I am usually in the camp that believes that States should regulate professionals within their jurisdiction. However, in this case, the State bars as a whole have failed. They have provided no specific ethical rule of conduct to remedy this kind of situation. Even if they do have a general rule that applies, it often goes unenforced.

148 CONG. REC. S6554-56 (daily ed. July 10, 2002) (statement of Sen. Enzi).

8. See generally Cramton, Cohen & Koniak, *supra* note 1 (comparing SEC ethical rules to revised ABA Model Rules).

incentives on future enforcement efforts in this area. Brief concluding remarks follow.

## II. BUDGET AND PERSONNEL CONSTRAINTS AT THE SEC

In support of rigorous federally based standards of lawyer conduct, Professor Koniak has argued elsewhere that state bar authorities are unlikely to reliably enforce ethics rules against “big-time securities or corporate lawyer[s],” in part because bar authorities are “notoriously underfunded and under-staffed.”<sup>9</sup> There is little basis for disputing these contentions. Ample empirical evidence supports the view that lawyers at large prestigious firms are rarely the targets of disciplinary proceedings—most state bar disciplinary proceedings involve solo practitioners and small firm lawyers.<sup>10</sup> Money, or the lack thereof, is certainly part of the story. Generally, state bar authorities are on tight budgets and do not have the staff or budgets to pursue complex transactional cases.<sup>11</sup>

Unfortunately for proponents of a substantial SEC role in enforcing professional responsibility standards, the SEC faces similar budgetary constraints despite its recent large increases in budget allocations. The SEC is certainly better funded and has more expertise in securities matters than state bar authorities. But a short review of the resources available to the SEC and its oversight responsibilities in the securities markets suggests that it too may not have sufficient funding to provide the kind of sustained, rigorous oversight of the entire corporate and securities bar that proponents of an active SEC role appear to contemplate.

The SEC (with a staff of a little over 3,000) oversees 9 national securities exchanges, the over-the-counter market, 70 alternative trading systems, 12 registered clearing agencies, 8,000 registered broker-dealers that employ over 700,000 registered representatives, 8,000 transfer agents,

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9. Susan P. Koniak, *Law and Truth: Roundtable, The Lawyer's Responsibility to the Truth*, 26 HARV. J.L. & PUB. POL'Y 195, 215 (2003) [hereinafter Koniak, *Law and Truth*] (noting that “[i]ncreasing the funding for bar counsel's offices is simply not a viable plan because bringing even a single case or disciplinary proceeding against a big-time corporate law firm would be too difficult and would quickly eat up whatever extra money the state had added to the bar counsel's budget”). The authors make the same argument here. See generally Cramton, Cohen & Koniak, *supra* note 1.

10. See generally RICHARD L. ABEL, *AMERICAN LAWYERS* 144-45 (1989); Office of the State Bar of California Chief Trial Counsel, *Correlation of Firm Size and Practice Area with Complaints Received and Action Taken*, in DEMOGRAPHIC AND PROFESSIONAL CHARACTERISTICS OF CALIFORNIA ATTORNEYS 15 (1997).

11. See ABEL, *supra* note 10, at 148-49 (discussing state resources). Lack of resources, however, is not the only reason why disciplinary actions appear to be concentrated among small firms. Other factors seem to play a role as well, such as the frequency of certain professional breaches among small firms and the lack of support systems at such firms. See Ted Schneyer, *Professional Discipline for Law Firms?*, 77 CORNELL L. REV. 1, 7-8 (1992) (describing factors that prevent disciplinary actions against large firms); Fred C. Zacharias, *The Professional Discipline of Prosecutors*, 79 N.C. L. REV. 721, 756 n.119 (2001) (noting that most disciplinary proceedings are against small firms).

5,000 investment companies, 7,400 investment advisers and 14,000 issuers.<sup>12</sup> To be sure, the SEC does not have sole responsibility over these entities and individuals—self-regulatory agencies and state securities commissioners play an important oversight role as well. But the SEC remains the lead regulator in the securities markets and it continues to face additional demands on its budgetary and staff resources. For example, in just the last few months, there have been calls for increased SEC oversight of mutual and hedge funds.<sup>13</sup>

Until 2002 and the increased budget resources that came with the passage of Sarbanes-Oxley,<sup>14</sup> the SEC was on a starvation diet. Throughout the 1990s, as the securities markets became larger, more complex and increasingly global, and as financial engineers churned out increasingly more exotic instruments, the Commission's resources lagged farther and farther behind its workload. Prior to 1993, available staff resources kept pace with increases in the SEC's workload, but then largely remained flat throughout the remainder of the decade while workload increased tremendously. From 1992 through 2000, registered representatives under SEC supervision swelled from 427,000 to approximately 683,000 while the value of exchange-listed stock grew from \$3.97 to \$11.73 trillion.<sup>15</sup> Overall, from 1990 through 2000, the SEC's enforcement staff grew by only 16% while the number of complaints grew 100%.<sup>16</sup> The percentage of corporate filings that received a full or partial review dropped from 21% in 1990 to 8% in 2000.<sup>17</sup>

The end result was that by 2000, resource constraints had contributed to substantial delays in the SEC's rulemaking and oversight activities and had forced the Commission to be both more selective and slower in completing its enforcement efforts.<sup>18</sup> The SEC lobbied for larger budgets to avert these problems, but its pleas for increased funding during the 1990s

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12. See U.S. Gen. Accounting Office, GAO-02-302, SEC Operations: Increased Workload Creates Challenges 3 (Mar. 2002), available at <http://www.gao.gov/new.items/d02302.pdf> [hereinafter GAO, SEC Operations].

13. See, e.g., Stephen Labaton, *Funds Under Suspicion: The Overview*, N.Y. TIMES, Nov. 4, 2003, at A1 (describing bipartisan congressional criticism of lack of SEC oversight of mutual fund industry); Leslie Wayne, *Congress to Debate Greater Oversight of Hedge Funds*, N.Y. TIMES, Oct. 1, 1998, at C1 (noting criticism of lack of SEC regulation of hedge funds); see also SEC, IMPLICATIONS OF THE GROWTH OF HEDGE FUNDS 12 (2003), available at <http://www.sec.gov/news/studies/hedgefunds0903.pdf> ("[T]he Commission should consider regulatory and other measures to improve the current system of hedge fund regulation and oversight.").

14. See generally Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

15. See JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 630-31 (3d ed. 2003).

16. See GAO, SEC Operations, *supra* note 12, at 13-14.

17. See *id.* at 22.

18. See *id.*

were largely ignored.<sup>19</sup> Particularly in the latter half of the 1990s, the SEC was saddled with no-growth budgets and personnel freezes.<sup>20</sup>

These funding problems contributed to substantial staffing problems. Staff turnover, driven in part by large pay differentials between the SEC and other financial regulators,<sup>21</sup> is higher at the SEC than elsewhere in the government. In 2000, the turnover rate among attorneys, accountants and other professionals at the SEC was 15%, about twice the rate for equivalent positions outside of the SEC.<sup>22</sup> About one third of the SEC's staff left between 1998 and 2000.<sup>23</sup> Among other problems, this high turnover rate has a negative impact on the SEC's enforcement efforts because it creates a more inexperienced staff and slows down investigations and case processing, as new attorneys are trained or get up to speed on pending cases.

The SEC's traditional inability to fill vacant positions quickly exacerbates turnover problems. For example, in September 2001, the SEC had approximately 280 vacant positions.<sup>24</sup> The SEC's staffing problems appear to have flowed in part from the different funding mechanisms among financial regulators. Unlike the Federal Reserve, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, the SEC is not self-funded.<sup>25</sup> Instead, the Commission is part of the normal federal budgeting process.

Are these budget and staffing problems a thing of the past? I suspect not. While Sarbanes-Oxley did increase the size of the SEC's budget,<sup>26</sup> it

19. See SELIGMAN, *supra* note 15, at 630-39.

20. See *id.*

21. See U.S. Gen. Accounting Office, GAO-01-947, Securities and Exchange Commission: Human Capital Challenges Require Management Attention 2 (Sept. 2001), available at <http://www.gao.gov/new.items/d01947.pdf> (noting that SEC staff earn 18-39% less than comparable staff at other federal financial regulators).

22. See *id.* at 1.

23. See *id.*

24. See *id.*

25. Self-funded banking regulators are funded from fees and assessments as well as earnings on investments. See GAO, SEC Operations, *supra* note 12, at 29 n.34. Self-funding is feasible at the SEC, as it typically collects fees that are well in excess of its annual budgetary allocations. For example, in 2000, the SEC collected \$2.271 billion in fees, about 6 times more than its budget of \$370 million. See 2000 SEC ANN. REP. 158, available at <http://www.sec.gov/pdf/annrep00/ar00full.pdf>. Not surprisingly, those fees generally keep pace with increases in the SEC's workload. Although former Chairman Arthur Levitt sought to move the SEC to a self-funding model, he was unable to do so and ultimately concluded that Congress was unwilling to relinquish budgetary authority over the agency because doing so would give Congress far less control over the SEC's actions. See SELIGMAN, *supra* note 15, at 632.

26. The Act increased SEC appropriations for fiscal year 2003 to \$776 million, a 66% increase from the \$466.9 million in President Bush's original budget proposal. See generally 15 U.S.C. § 78kk (2003). About 30% of that increase was earmarked to add 200 employees for auditor oversight and to improve the Commission's "investigative and disciplinary effort." *Id.* Another third of the increase was slated to raise the pay of SEC employees to levels commensurate with other

is by no means certain in a time of increased budget deficits and shifting spending priorities (i.e., the war on terrorism, Iraq, homeland security) that the SEC can count on those budget increases in the future. Indeed, prior to the passage of Sarbanes-Oxley, the president's initial budget proposal for 2003 did not fund an enacted pay parity law that would have increased SEC staff salaries to levels commensurate with staff at other financial regulators.<sup>27</sup> Even after Sarbanes-Oxley's increased appropriations, budget negotiations between the president and Congress showed the same kind of political wrangling as in past years.<sup>28</sup> Also, even with the increases now in place, the SEC has still had significant difficulty filling authorized positions with qualified individuals.<sup>29</sup> Thus, like any governmental enforcement authority, the SEC will have to carefully allocate its resources in order to maximize deterrence.

Will the SEC allocate substantial resources to attorney disciplinary actions? A number of factors suggest that such an allocation is unlikely, at least in the foreseeable future. The SEC faces enormous pressure from Congress and other constituencies to bring enforcement actions involving the primary actors in Enron and other recent scandals; it is reasonable to assume that, at least in the short term, the SEC will concentrate its enforcement resources there. Over the long term, I think Professors Cramton, Cohen and Koniak are right that the SEC has virtually assured low-

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financial regulators. *See id.* The SEC was to use the remaining increase for technology and security enhancements and for expenses related to September 11, 2001. *See id.*

27. *See generally* Investor & Capital Markets Fee Relief Act, Pub. L. No. 107-123, 115 Stat. 2390 (2002); Floyd Norris, *Will S.E.C.'s Needs Be Met? Not by Bush*, N.Y. TIMES, Feb. 8, 2002, at C1 ("Congress finally passed legislation last year to pay S.E.C. people what bank regulators are paid, but President Bush's new budget provided no money for pay parity or for hiring a single additional accountant.").

28. Despite the \$776 million that Sarbanes-Oxley authorized for the SEC's budget, President Bush's first budget proposal, citing other drains on resources such as increased military spending and security against terrorism, requested only \$568 million in funding, which was about 27% less than authorized. *See* Stephen Labaton, *Bush Tries to Shrink S.E.C. Raise Intended for Corporate Cleanup*, N.Y. TIMES, Oct. 19, 2002, at A1. Democrats pushed for a budget increase in line with the Sarbanes-Oxley authorization and argued that the administration was reneging on its earlier commitment because corporate scandals had moved off the front pages of the newspaper. *See id.*; *see also* Kathleen Day, *SEC Funds Get Snarled in Dispute; Hill Democrats Want Bigger Boost than Bush*, WASH. POST, Oct. 22, 2002, at E1. The administration eventually bowed to political pressure and said it would seek a budget for the SEC of \$842 million, 92% larger than the SEC's budget from the previous year. *See* Stephen Labaton, *Bush Proposes Big Increase in S.E.C. Budget*, N.Y. TIMES, Feb. 3, 2003, at C1.

29. *See* GAO, SEC Operations, *supra* note 12, at 5 (remarking that "more remains to be done in order for [the] SEC to strategically align its core mission with its ability to recruit and retain qualified employees"); Stephen Labaton, *S.E.C. Chief Says Fixing the Agency Will Take Time*, N.Y. TIMES, Mar. 13, 2003, at C1 (quoting SEC Chairman William Donaldson as remarking that new funding "present[s] challenges" in terms of hiring staff who do not just "increase head count" but also "can perform the vital tasks that we assign to them").

level enforcement by adopting its convoluted triggering mechanism for up-the-ladder reporting.<sup>30</sup>

It is possible, of course, to argue that vigorously enforcing up-the-ladder reporting rules and requiring noisy withdrawal will actually conserve resources in the long run by effectively enlisting lawyers as additional monitors of client misbehavior.<sup>31</sup> Empirical studies of deterrence strongly suggest that, all other things being equal, increased monitoring (which increases the chances that unlawful activities will be detected) has a greater deterrent impact than enhanced sanctions.<sup>32</sup> As suggested earlier, even if enforcement activity does not increase significantly, the mere presence of Section 307 and the amendments to the ABA Model Rules are likely to cause more lawyers to report evidence of illegal acts up the ladder. But the question remains—is the SEC likely to make disciplining lawyers an enforcement priority? Answering that question requires us to take a somewhat closer look at the institutional features of the SEC as an enforcement agency.

### III. SEC ENFORCEMENT OF ATTORNEY PROFESSIONAL RESPONSIBILITY: A BRIEF ANALYSIS OF INSTITUTIONAL INCENTIVES AND CONSTRAINTS

The case for augmenting the SEC's role in disciplining lawyers is premised largely on the inadequacies of state bar authorities. The standard critique, in addition to highlighting the funding problems previously discussed, paints a picture of generally lax and inconsistent enforcement of professional responsibility standards. When they were first formed, state bar authorities rarely enforced professional responsibility rules.<sup>33</sup> Although disciplinary actions have increased over time, they tend to follow distinct patterns. Most actions are brought against individual lawyers in small law firms or solo practitioners; large firm lawyers are rarely subject to

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30. See Cramton, Koniak & Cohen, *supra* note 1 at \_\_\_. See generally Susan P. Koniak, *When the Hurlyburly's Done: The Bar's Struggle with the SEC*, 103 COLUM. L. REV. 1236, 1275 (2003) [hereinafter Koniak, *Hurlyburly*].

31. See, e.g., John C. Coffee, Jr., *The Attorney as Gatekeeper: An Agenda for the SEC*, 103 COLUM. L. REV. 1293, 1294 (2003). Many commentators disagree; they suggest that clients are less likely to confide in lawyers if attorney-client privilege rules are relaxed. See, e.g., Fisch & Rosen, *supra* note 6, at 1138 (arguing that SEC "provision threatens to undermine the flow of information between lawyers and corporate actors"); Lawrence J. Fox, *It Takes More Than Cheek to Lose Our Way*, 77 ST. JOHN'S L. REV. 277, 283 (2003).

32. See Erling Eide, *Economics of Criminal Behavior*, in ENCYCLOPEDIA OF LAW & ECONOMICS 345, 359 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000) (reviewing literature); see also JAMES Q. WILSON & RICHARD J. HERRNSTEIN, *CRIME AND HUMAN NATURE* 398 (1985); Jeffrey Grogger, *Certainty vs. Severity of Punishment*, 29 ECON. INQUIRY 297, 304 (1991). See generally Isaac Ehrlich, *Participation in Illegitimate Activities: A Theoretical and Empirical Investigation*, 81 J. POL. ECON. 521 (1973).

33. See ABEL, *supra* note 10, at 143, 145-46.



discipline.<sup>34</sup> Most complaints are dismissed with apparently little investigation.<sup>35</sup> The matters in which state bar authorities actually bring disciplinary actions typically involve obvious professional lapses, such as mishandling of client funds.<sup>36</sup> A large percentage of disbarments involve clear-cut cases of lawyer misconduct or unfitness, such as those involving lawyers with felony convictions.<sup>37</sup>

What is most striking about this critique (at least to this securities professor) is that it could equally describe most of the SEC's own history in enforcing professional responsibility standards against attorneys. In a highly condensed form, that history goes something like this. Since its second year of operation (1935), the SEC has had the power under Rule 102(e) of its Rules of Practice to suspend or disbar attorneys from appearing or practicing before the Commission if they engage in improper professional conduct.<sup>38</sup> Like state bar authorities, in the earliest days, the Commission did not exercise its power to discipline attorneys. In the first fifteen years of its existence, Rule 102(e) was used only in disciplinary proceedings against accountants and other non-legal professionals appearing before the Commission. It was not until 1950 that the SEC used Rule 102(e) to suspend an attorney from practicing before the SEC.<sup>39</sup> Throughout the 1950s and 1960s, there was a similar low level of activity.<sup>40</sup>

Things changed in the 1970s. Under the direction of Irving Pollack and his successor as head of the Enforcement Division, Stanley Sporkin, the Commission shifted from generally low to more vigorous enforcement.<sup>41</sup> In those cases which were brought under what the Enforcement Division termed an "access theory" of securities enforcement,<sup>42</sup> the Commission articulated a vision of Rule 102(e) that is remarkably similar to

34. See *id.* at 144-45; Schneyer, *supra* note 11, at 7-8 (reporting that "[p]roceedings against lawyers in large or even medium-sized firms are very rare"); cf. DEBORAH L. RHODE, IN THE INTERESTS OF JUSTICE: REFORMING THE LEGAL PROFESSION 159 (2000) (noting that "[m]any disciplinary agencies also are reluctant to pursue powerful bar leaders").

35. See, e.g., ABEL, *supra* note 10, at 147.

36. See *id.* at 150-51. Professors Cramton, Cohen and Koniak report that they are unaware of any disciplinary proceedings brought against lawyers who failed to report up the ladder. See Cramton, Cohen & Koniak, *supra* note 1, at \_\_\_\_.

37. See ABEL, *supra* note 10, at 145, 148; RHODE, *supra* note 34, at 159.

38. See 17 C.F.R. § 201.102(e) (2003). The predecessor to Rule 102(e) was adopted in only the SEC's second year of operation. See generally SEC R. PRAC. II(1) (1935). For ease of exposition, this paper will refer to this rule by its current designation, Rule 102(e).

39. See *In re Fleischmann*, Release No. U-115, 37 S.E.C. 832, 832 (1950), 1950 WL 40380.

40. See generally *In re Keating*, Muething & Klekamp, Exchange Act Release No. 15982, 47 S.E.C. 95, 109 (1979) (Karmel, Comm'r, dissenting).

41. See *id.* at 112 (noting that SEC brought in excess of eighty-five cases against attorneys during 1970s); SELIGMAN, *supra* note 15, at 540.

42. See generally SEC HISTORICAL SOC'Y, ORAL HISTORIES COMM., ROUNDTABLE ON ENFORCEMENT: A BRIEF HISTORY OF THE SEC'S ENFORCEMENT PROGRAM 1934-1981 27 (Sept. 25, 2002), available at <http://www.sechistorical.org/museum/Mu>

that expressed by proponents of Section 307. Then, as now, the lawyer was viewed as a gatekeeper who could be enlisted through the threat of disciplinary action to protect shareholders from managerial opportunism.<sup>43</sup>

Aggressive access theory enforcement, however, was relatively short-lived and effectively came to an end in the early 1980s. At that point, the SEC reverted to its previous pattern; indeed, it formally took the position that it would only bring Rule 102(e) proceedings against attorneys "if the alleged misconduct was a violation of established ethical rules at the state level and had a direct impact on the Commission's internal processes."<sup>44</sup>

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43. See *In re Fields*, Securities Act Release No. 5404, 45 S.E.C. 262, 266 n.20 (1973) (finding that SEC's power to suspend attorneys was essential because "the task of enforcing the securities laws rests in overwhelming measure on the bar's shoulders" and that SEC, "with its small staff, limited resources, and onerous tasks is peculiarly dependent on the probity and the diligence of the professionals who practice before it"); Coffee, *supra* note 31, at 1310-15. The rhetoric then and now is remarkably similar. Enforcement Division Director Sporkin explained the access approach:

The Commission has found that the impact of its enforcement efforts is best maximized by concentrating those efforts on the strategic access points to our securities market. What I am describing is an "access" approach to enforcement.

We all recognize that a major securities fraud cannot be perpetrated by a corporation, its officers and directors without access to our financial markets . . . . [S]ystematized frauds frequently depend on the cooperation, intentional or otherwise, of professionals such as lawyers and public accountants. Many of the most egregious frauds of the past few years—frauds resulting in losses to investors of hundreds of millions of dollars—have involved the full panoply of professional participation.

HISTORY OF SEC ENFORCEMENT, *supra* note 42, at 27 (quoting Stanley Sporkin, SEC Enforcement Practices Against Corporations, Speech to the Corporate Counsel Institute (Oct. 7, 1976)). As Yogi Berra might say, "It's déjà vu all over again."

44. 10 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 4883 (3d ed. rev. 1996). A full discussion of the reasons underlying this shift back to relatively infrequent enforcement is beyond the scope of this paper. In part, this shift had to do with active opposition by the securities bar to the SEC's role in this area. See Koniak, *Hurlyburly*, *supra* note 30, at 1260 (describing securities bar's criticism of SEC's role in setting and enforcing professional responsibility standards). In part, it had to do with discomfort with the dual role the SEC was playing of prosecutor and attorney disciplinarian. See generally *In re Keating*, Muething & Klekamp, 47 S.E.C. at 109 (Karmel, Comm'r, dissenting). And, in part it had to do with a shift in personnel at the SEC and the departure of some of the key access theory champions. See Coffee, *supra* note 31, at 312-14 (detailing personnel changes at SEC); see also PHILIP P. HEYMANN, THE POLITICS OF PUBLIC MANAGEMENT 12-15 (1987) (discussing critical role that agency executives play in changing administrative priorities); JAMES Q. WILSON, BUREAUCRACY: WHAT GOVERNMENT AGENCIES DO AND WHY THEY DO IT 218-32 (1990) (same). Simply put, when a discretionary enforcement program runs counter to the norms and incentives of the agency's staff (something I address in a bit more detail below) and faces active opposition by powerful interest groups, it is only natural that the agency's enthusiasm for the program will wane when that influential champion leaves the agency. Although such a champion might emerge at the SEC, I think that individuals that can overcome an agency's inherent constraints and biases are relatively rare. As a result, I

Since then, nearly all Rule 102(e) proceedings against lawyers have involved actual securities law violations,<sup>45</sup> a pattern that is quite consistent with state bar disciplinary proceedings against lawyers with felony convictions.<sup>46</sup> Like state bar authorities, the SEC has tended to bring these proceedings against solo practitioners or lawyers from small firms.<sup>47</sup> Thus, except for the period of aggressive enforcement in the 1970s, the SEC's enforcement of disciplinary rules against lawyers has looked remarkably similar to state bar authorities' enforcement efforts.

These similarities are not mere coincidence. State bar authorities and the SEC are both bureaucracies that share a common set of cultural norms and institutional constraints. First, from its inception and throughout its history, the SEC has been a lawyer-dominated agency.<sup>48</sup> Lawyer domination does not mean knee-jerk protectionism. It is far too facile to suggest that a lawyer-dominated agency will simply look out for its own and never bring actions against attorneys. At least at the SEC, the historical evidence shows that lawyers do not get a free pass; they are frequently defendants in SEC actions, particularly actions alleging insider trading violations.<sup>49</sup> That being said, however, lawyers' professional norms and experiences are likely to have a profound impact when it comes to enforcing professional responsibility rules that SEC staffers may consider to be outside of the agency's core mission (to protect investors by vigorously enforcing disclosure obligations). Professor Koniak has suggested that client confidentiality and zealous advocacy are "constitutional" norms for lawyers—core values that lawyers treat as nearly inviolable.<sup>50</sup> As a result, disclosing client fraud is subordinate to the central norm of maintaining confidentiality.<sup>51</sup> The attorney commissioners and staffers, many of whom practiced as se-

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believe that the pattern of SEC attorney discipline that prevailed through approximately sixty of the SEC's seventy years is the best long-term predictor of the SEC's future behavior.

45. See LOSS & SELIGMAN, *supra* note 44, at 4883-84; see also Disciplinary Proceedings Involving Professionals Appearing or Practicing Before the Commission, Exchange Act Release No. 34-25893, 53 Fed. Reg. 26427 (July 13, 1988) ("The great majority of Rule [102(e)] proceedings against attorneys involve allegations of violations of *law* (not of professional standards); thus, the Commission, as a matter of policy, generally refrains from using its administrative forum to conduct *de novo* determinations of the professional obligations of attorneys.").

46. See ABEL, *supra* note 10, at 145 (noting that many disbarments involve attorneys with felony convictions).

47. See, e.g., *In re Fleischmann*, Release No. U-115, 37 S.E.C. 832, 832 (1950), 1950 WL 40380.

48. See HOMER KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* 18 (1979).

49. See, e.g., *United States v. O'Hagan*, 521 U.S. 642, 648 (1997) (discussing indictment against attorney for insider trading); *SEC v. Fehn*, 97 F.3d 1276, 1286 (9th Cir. 1996) (describing SEC enforcement action against attorney for aiding and abetting securities fraud).

50. See generally Susan P. Koniak, *The Law Between the Bar and the State*, 70 N.C. L. REV. 1389, 1411 (1992).

51. See Koniak, *Hurlyburly*, *supra* note 30, at 1250.

curities lawyers before joining the SEC, share the very same professional norms advanced by Professor Koniak.

In this regard, the SEC or state bar authorities are no different from other administrative agencies staffed by professionals. Professionals (not just lawyers, but economists, engineers and others) within agencies often receive incentives (in terms of status, deference and post-government employment opportunities) from “organized groups of fellow practitioners located outside the agency.”<sup>52</sup> It is, thus, unsurprising that the SEC would vigorously enforce insider trading rules against attorneys because such activity is both at the core of the SEC’s investor protection mission and blatantly breaches a lawyer’s confidentiality norm. At the same time, finding a plausible interpretation that supports a client’s disclosure decision or transaction structure is at the heart of the zealous advocacy norm, and we should not be surprised that the SEC would be less willing to discipline lawyers for that activity.

As lawyers themselves, the SEC staff is also likely to be more acutely attuned to the hindsight bias problem implicated in determining after the fact what a lawyer must have known. Cognitive psychologists have repeatedly found that people reviewing a set of facts *ex post* consistently exaggerate what could have been anticipated *ex ante*. In other words, when individuals know an outcome, they tend to believe “that others should have been able to anticipate events much better than was actually the case.”<sup>53</sup>

Hindsight bias has obvious implications for enforcement of up-the-ladder reporting rules.<sup>54</sup> To be sure, Professor Koniak argues that lawyers never “know” that their clients are acting improperly,<sup>55</sup> and there is certainly some truth to that position. Lawyers, just like anyone else, can conveniently delude themselves about the existence of improper activities, particularly where they have a strong financial incentive to do so.<sup>56</sup> But it is also true that it is all too easy in hindsight to say that a lawyer “must have known” of client misbehavior, when, in reality, at the time the lawyer was

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52. WILSON, *supra* note 44, at 60. Wilson states further:  
[T]he behavior of a professional in a bureaucracy is not wholly determined by incentives controlled by the agency . . . [b]ecause the behavior of the professional is not entirely shaped by the organizational incentives, the way such a person defines his or her task may reflect more the standards of the external reference group than the preferences of the internal management.

*Id.*

53. Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571, 572 (1998).

54. See GEOFFREY C. HAZARD, JR. ET AL., *THE LAW AND ETHICS OF LAWYERING* 303 (3d ed. 1999) (“The fact-finder, knowing that the fraud took place, will be inclined to exaggerate the degree to which the lawyer was aware of the client’s fraudulent purpose or knowingly assisted in its accomplishment.”).

55. See Koniak, *Law and Truth*, *supra* note 9, at 212.

56. See Donald C. Langevoort, *Where Were the Lawyers? A Behavioral Inquiry into Lawyers’ Responsibility for Clients’ Fraud*, 46 VAND. L. REV. 75, 98 (1993).

acting, the facts may have appeared much less clear.<sup>57</sup> Moreover, constructing a positive initial image of a client and then clinging to that initial impression, even in the light of apparently inconsistent evidence, is not necessarily venal. Again, cognitive psychology teaches that once humans (and, despite some suggestions to the contrary, lawyers are human) construct schema (i.e., mental representations used to process incoming data), they are generally reluctant to alter them.<sup>58</sup>

While lawyers at the SEC are not immune from the hindsight bias problem,<sup>59</sup> they are likely to have a greater familiarity with the indeterminate context in which securities lawyers advise clients on, for example, disclosure issues and, therefore, may be reluctant to bring disciplinary proceedings against them.<sup>60</sup> It is, thus, not surprising to see bar officials and SEC enforcement attorneys focusing their disciplinary efforts almost exclusively on the most egregious cases (such as stealing client funds or insider trading), where such uncertainties are less of a concern. And to the extent that the SEC has admonished or disciplined lawyers for reporting failures, it has generally been in cases with compelling facts that strongly suggest lawyer knowledge of client misbehavior.<sup>61</sup>

This implicit recognition of the hindsight bias problem may also explain why the SEC adopted such a convoluted triggering mechanism for up-the-ladder reporting. As Professors Cramton, Cohen and Koniak discuss, under the rule as adopted, the lawyer's reporting obligation is only triggered if the lawyer becomes aware of "credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur."<sup>62</sup> If the presence of hindsight bias suggests a significant risk of lawyer discipline in situations in which the lawyer did not know of a client's wrongdoing, then adopting a convoluted and difficult standard is a way of ensuring that dis-

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57. See Fox, *supra* note 31, at 284.

58. See Langevoort, *supra* note 56, at 101.

59. Cf. Rachlinski, *supra* note 53, at 580-81 nn.29-30 (collecting studies finding presence of hindsight bias in number of populations, including federal judges and auditors).

60. See RHODE, *supra* note 34, at 160 ("Many of the judges and bar leaders who regulate the regulators have a 'there but for the grace of God go I' attitude toward all but the most serious misconduct.").

61. See SEC v. Nat'l Student Mktg. Corp., 457 F. Supp. 682, 685-713 (D.D.C. 1978) (when accountants at closing refused to provide required comfort letter and instead detailed material misstatements in financials, court held that "significance of the information clearly removes any doubt concerning [attorneys' knowledge of] the materiality of the information,"); *In re Gutfreund*, Exchange Act Release No. 34-31554, 51 S.E.C. 93, 95 (1992) (finding that chief legal officer of broker-dealer was aware of false bid submitted in Treasury auction, advised that facts be disclosed to government and knew that management had not disclosed information).

62. 17 C.F.R. § 205.2(e) (2003).

cipline will be imposed only in cases in which the lawyer really did know.<sup>63</sup> To be sure, such a standard is a second-best solution. It would be far preferable for enforcement attorneys to assess hindsight bias accurately in individual cases, but expecting that kind of accuracy is unrealistic. Given the drafters' professional norms and the centrality of the confidentiality principle, it is unsurprising to see them adopt a standard that will tend to under- rather than over-discipline attorneys for reporting failures.

In addition to these professional norms, it is also important to recognize that normal prosecutorial preferences will impact SEC enforcement attorneys' decisions whether to bring disciplinary actions. In deciding which cases to bring, the Commission will certainly focus on the potential benefits of enforcement, such as whether enforcement will have an important deterrent impact.<sup>64</sup> Thus, a high-profile case against a prestigious law firm that is likely to generate substantial press coverage has obvious appeal. But that kind of case is a double-edged sword, both because of the downside risk associated with losing a high-profile case and because such cases are likely to require greater staff resources to prosecute. Particularly when it comes to bringing the first test cases, the Commission is likely to have a strong preference for cases in which there is clear evidence that the lawyer violated his or her reporting obligations. In other words, we are likely to continue to see the same pattern we saw before Sarbanes-Oxley—cases in which the violation of the SEC's Rules of Practice is essentially an add-on to a claim that the lawyers were themselves engaged in securities violations.<sup>65</sup>

The same conclusion flows from an analysis of the incentives of the staff enforcement attorneys. As the previously discussed turnover data suggest, typical SEC enforcement staffers are young attorneys who spend only a few years at the SEC before pursuing more lucrative careers in private practice, often at large prestigious law firms.<sup>66</sup> While one way to enhance career advancement within the agency and post-government employment opportunities is to bring high profile cases,<sup>67</sup> attorneys may, quite frankly, be leery of bringing disciplinary proceedings against lawyers from the kind of firms that they hope to join in the future.<sup>68</sup> The reluctance to bring a

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63. See Rachlinski, *supra* note 53, at 575 (describing how courts employ legal standards, such as business judgment rule, to compensate for effects of hindsight bias).

64. See SUSAN P. SHAPIRO, *WAYWARD CAPITALISTS: TARGET OF THE SECURITIES AND EXCHANGE COMMISSION* 150-51 (1984).

65. See Zacharias, *supra* note 11, at 760 ("As a practical matter, faced with no shortage of other cases involving professional misconduct, the authorities may prefer to use their limited resources to dispose of a greater number of easier cases.").

66. See SHAPIRO, *supra* note 64, at 141-42.

67. See ROBERT A. KATZMANN, *REGULATORY BUREAUCRACY: THE FEDERAL TRADE COMMISSION AND ANTITRUST POLICY* 71 (1980); Arthur Maass, *U.S. Prosecution of State and Local Officials for Political Corruption*, 17 *PUBLIUS* 195, 222-27 (1987).

68. While this concern is understandable, it is by no means clear that this kind of proceeding would inhibit future job prospects. High profile prosecutions, even if they are contrary to interests of industry, could make lucrative industry jobs

disciplinary proceeding against a lawyer, however, may be lessened if the subject of the disciplinary proceeding can be portrayed as a rogue attorney who clearly was acting outside the norms of the profession, or if the attorney is a solo practitioner or member of a small firm. Again, it seems that staff attorneys will display the same preferences they have in the past—they will prefer to bring only the most egregious actions, especially if the lawyers involved are from less prestigious firms.

An obvious example of this kind of enforcement pattern is the recent history of enforcement under Section 10A of the Securities Exchange Act.<sup>69</sup> Adopted as part of the Private Securities Litigation Reform Act of 1995,<sup>70</sup> Section 10A imposes a reporting duty on auditors similar to the Section 307 requirements.<sup>71</sup> Section 10A requires auditors to report to the SEC illegal acts that have a material impact on financial statements if management or the board fails to take appropriate remedial action after being notified of those acts.<sup>72</sup> Despite record levels of accounting restatements and a substantial number of SEC enforcement actions that allege accounting improprieties,<sup>73</sup> the SEC has only received twenty-nine Section 10A reports since the provision has taken effect.<sup>74</sup> Although it would seem that there would be many opportunities for the SEC to pursue cases against accountants for failure to comply with their reporting obligations, through mid-2003, the SEC had brought only seven actions alleging that auditors violated the reporting requirements of Section 10A.<sup>75</sup> Most of these actions, as would have been predicted from an analysis of the norms and constraints of the staff, involved accountants from smaller, less prestigious firms who appear to have either known or been complicit in obvious financial misreporting.<sup>76</sup> For the most part, the alleged Section 10A viola-

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more attainable because they demonstrate talent and energy. *See WILSON, supra* note 44, at 86. Nonetheless, when a lawyer's own future earnings potential is on the line, the attorney may be risk averse.

69. *See* 15 U.S.C. § 78j-1 (1995).

70. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.).

71. *See* 15 U.S.C. § 78j-1.

72. *See id.* § 78j-1(3).

73. During fiscal year 2002, the SEC's Division of Enforcement processed six hundred enforcement cases, 23% of which involved accounting or auditing issues. *See* U.S. Gen. Accounting Office, GAO-03-982R, Securities Exchange Act: Review of Reporting Under Section 10A 4 (Sept. 3, 2003), *available at* <http://www.gao.gov/new.items/d03982r.pdf>.

74. *See id.* at 5.

75. *See id.* at 1.

76. *See, e.g., In re Decker*, Exchange Act Release No. 47731, 80 SEC Docket 80 (Apr. 24, 2003), 2003 SEC LEXIS 980 (involving improper recording of not yet consummated merger that permitted issuer to overstate revenues by 177% in situation in which auditor possessed evidence that management fabricated documents); *In re Ohlhauser*, Exchange Act Release No. 47256, 79 SEC Docket 1432 (Jan. 27, 2003), 2003 SEC LEXIS 221 (involving allegation that Canadian auditor did not report potential illegal act to management even though he reasonably concluded that licensing agreement accounting for 40% of issuer's quarterly profits

tions appeared to be add-ons to claims that the auditors violated the federal securities laws. There seems to be no substantial reason to believe that enforcement under Section 307 will look any different.

#### IV. CONCLUSION

When it comes to enforcing professional responsibility standards, the SEC and state bar authorities are subject to similar constraints and incentives and exhibit similar norms. As a result, it is reasonable to expect that SEC enforcement of the new lawyer reporting rules will look quite similar to its own past enforcement patterns and the enforcement patterns that state bar authorities exhibit. But incentives, norms and constraints are not outcome-determinative. Bureaucracies can overcome these barriers and change their behavior, broaden their agendas or reconceptualize their missions. Indeed, one need look no further for evidence of such a change than the SEC's own treatment of lawyers in the 1970s. Is such a shift back to vigorous enforcement possible in the future? Anything is possible, but history teaches us that lasting shifts (particularly those that are at odds with agency norms, incentives and constraints) are relatively rare.<sup>77</sup> In this case, past is most likely prologue.

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was backdated); SEC v. Skulsky, Litigation Release No. 17407, 77 SEC Docket 306 (Mar. 12, 2002), 2002 SEC LEXIS 547 (involving concurrent civil and criminal actions against small firm auditors who were implicated in revenue recognition and manipulation scheme).

77. See WILSON, *supra* note 44, at 218-32.



